United Nations E/C.18/2015/1

Economic and Social Council

Distr.: General
11 August 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh session
Geneva, 19-23 October 2015

Provisional agenda and organization of work

Provisional agenda

1. Opening of the session by the Chair of the Committee.
2. Adoption of the agenda and organization of work.
3. Discussion of substantive issues related to international cooperation in tax matters:
   - (a) Issues related to the updating of the United Nations Model Tax Convention:
     - (i) Article 1 (Persons covered): application of treaty rules to hybrid entities;
     - (ii) Article 5 (Permanent establishment): the meaning of "connected projects";
     - (iii) Article 8 (Shipping, inland waterways transport and air transport):
       - a. The meaning and coverage of the term "auxiliary activities";
       - b. The application of the article to cruise shipping;
       - c. Other commentary issues;
     - (iv) Base erosion and profit-shifting;
     - (v) Article 12 (Royalties):
       - a. The meaning of "industrial, commercial and scientific equipment";
       - b. Software payment-related issues;
     - (vi) Article 26 (Exchange of information): proposed Code of Conduct;

15-13115 (E) 010915

Please recycle

(vii) Taxation of services:

a. Article on technical services;

b. Other issues;

(b) Other issues:

(i) Issues for the next update of the United Nations Practical Manual on Transfer Pricing for Developing Countries;

(ii) Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;

(iii) Taxation of the extractive industries;

(iv) Taxation of development projects;

(v) Capacity-building;

(vi) Dispute settlement: arbitration issues for developing countries and possible ways forward;

(vii) International trade in goods — tax issues.

4. Dates and provisional agenda for the twelfth session of the Committee.

5. Adoption of the report of the Committee on its eleventh session.

Organization of work

Date	*Item*	
Monday, 19 October 2015		
9-10 a.m.		Registration of participants
10-10.45 a.m.	1	Opening of the session by the Chair of the Committee
	2	Adoption of the agenda and organization of work
	3	Discussion of substantive issues related to international cooperation in tax matters:
		(a) Issues related to the updating of the United Nations Model Tax Convention:
10.45-11.45 a.m.	3 (a) (i)	Article 1 (Persons covered): application of treaty rules to hybrid entities;
11.45 a.m.-12 p.m.		Coffee break
12-1 p.m.	3 (a) (ii)	Article 5 (Permanent establishment): the meaning of "connected projects"
1-3 p.m.		Lunch break
3-3.45 p.m.	3 (a) (iii)	Article 8 (Shipping, inland waterways transport and air transport):
		a. The meaning and coverage of the term "auxiliary activities";
		b. The application of the article to cruise shipping;
		c. Other commentary issues
3.45-4 p.m.		Coffee break
4-6 p.m.	3 (a) (iii)	Article 8 (Shipping, inland waterways transport and air transport) (continued)
Tuesday, 20 October		
10-11 a.m.	3 (a) (vii)	Taxation of services:
		a. Article on technical services;
		b. Other issues
11.45 a.m.-12 p.m.		Coffee break
12-1 p.m.	3 (a) (vii)	Taxation of services (continued)
1-3 p.m.		Lunch break
3-4 p.m.	3 (a) (vii)	Taxation of services (continued)

Date	*Item*	
4-4.45 p.m.	3 (b) (v)	Capacity-building
4.45-5 p.m.		Coffee break
5-6 p.m.	3 (b) (v)	Capacity-building (continued)
Wednesday, 21 October		
10-11.30 a.m.	3 (a) (iv)	Base erosion and profit-shifting
11.30-11.45 a.m.		Coffee break
11.45 a.m.-1 p.m.	3 (a) (v)	Article 12 (Royalties): a. The meaning of "industrial, commercial and scientific equipment"; b. Software payment-related issues
1-3 p.m.		Lunch break
3-4.30 p.m.	3 (a) (v)	Article 12 (Royalties) (continued)
4.30-4.45 p.m.		Coffee break
4.45-6 p.m.	3 (b) (i)	Issues for the next update of the Practical Manual on Transfer Pricing for Developing Countries
Thursday, 22 October		
10-10.30 a.m.	3 (b) (i)	Issues for the next update of the Practical Manual on Transfer Pricing for Developing Countries (continued)
10.30-11.30 a.m.	3 (b) (iii)	Taxation of the extractive industries
11.30-11.45 a.m.		Coffee break
11.45 a.m.-1 p.m.	3 (b) (iii)	Taxation of the extractive industries (continued)
1-3 p.m.		Lunch break
3-3.30 p.m.	3 (b) (iii)	Taxation of the extractive industries (continued)
3.30-5 p.m.	3 (a) (vi)	Article 26 (Exchange of information): proposed Code of Conduct
5-5.15 p.m.		Coffee break
5.15-6 p.m.	3 (b) (iv)	Taxation of development projects
Friday, 23 October		
10-11.45 a.m.	3 (b) (ii)	Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries
11.45 a.m.-12 p.m.		Coffee break

Date	*Item*	
12-1 p.m.	3 (b) (vi)	Dispute settlement: arbitration issues for developing countries and possible ways forward
1-3 p.m.		Lunch break
3-3.45 p.m.	3 (b) (vi)	Dispute settlement (continued)
3.45-5 p.m.	3 (b) (vii)	International trade in goods — tax issues
5-5.45 p.m.	4	Dates and provisional agenda for the twelfth session of the Committee
5.45-6 p.m.	5	Adoption of the report of the Committee on its eleventh session; closing of the session

United Nations E/C.18/2015/2

Economic and Social Council

Distr.: General
10 August 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh session
Geneva, 19-23 October 2015
Item 3 of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters

Addis Ababa Action Agenda: outcomes related to the work of the Committee of Experts on International Cooperation in Tax Matters

Note by the Secretariat

Summary

The present note provides a summary of the main elements of the Addis Ababa Action Agenda, which was adopted at the Third International Conference on Financing for Development, that are relevant to the work of the Committee of Experts on International Cooperation in Tax Matters.

* E/C.18/2015/1.

15-13116 (E) 010915

Please recycle

Summary of the provisions related to international cooperation in tax matters

1. As the Millennium Development Goals come to an end in 2015, the States Members of the United Nations will adopt a new global development agenda for the next 15 years at a summit in New York in September 2015.

2. The new agenda, entitled "Transforming our world: the 2030 agenda for sustainable development", includes 17 sustainable development goals and is aimed at ending poverty, promoting prosperity and people's well-being and protecting the environment by 2030.

3. The 2030 agenda can be achieved within the framework of a revitalized global partnership for sustainable development, supported by the specific policies and actions outlined in the Addis Ababa Action Agenda (resolution 69/313, annex), which was adopted at the Third International Conference on Financing for Development held in Addis Ababa from 13 to 16 July 2015, and endorsed by the General Assembly in its resolution 69/313.

4. The goal of the financing for development process, as mirrored in the outcome documents of the 2002 International Conference on Financing for Development (A/CONF.198/11) and the 2008 Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus (resolution 63/239, annex), has always been to forge a global agreement on how to address the challenges of financing development in a holistic and integrated manner.

5. The Action Agenda provides a strong foundation to support the implementation of the 2030 agenda. Official development assistance remains crucial, in particular for countries most in need, but aid alone will not be sufficient. The Action Agenda addresses all sources of finance: public and private, national and international. Governments recognize that finance not only is about financing flows; it also depends on public policies that strengthen the national and international enabling environments.

6. The Action Agenda highlights the principle that each country is responsible for its own economic and social development, while recognizing the regulatory and other policy requirements that will be needed to realize the economic, social and environmental dimensions of sustainable development. To address larger and more diverse financing needs for sustainable development, the Action Agenda offers a nuanced understanding of the benefits and the risks associated with various types of finance. It puts forward specific public policies and regulatory frameworks to encourage private investments that support the sustainable development goals, including more sustainable consumption and production patterns. It stresses the importance of long-term investment and that all financing must be aligned with sustainable development priorities. It spells out the potential contributions of public finance, highlighting the growing role of national and international development banks. It also emphasizes that development and dissemination of technology, as well as capacity-building, are key means of implementation for the post-2015 development agenda.

7. The Action Agenda clearly recognizes that taxation and international tax cooperation are critical to financing sustainable development. While "tax matters" were mentioned four times in the outcome document of the International Conference on Financing for Development, the Action Agenda refers to "tax issues" 35 times. Tax revenues are not a replacement for official development assistance, but they are a more reliable source of finance.

8. At the Third International Conference on Financing for Development, Governments agreed that they "remain committed to further strengthening the mobilization and effective use of domestic resources" (resolution 69/313, annex, para. 20). The Heads of State and Government and High Representatives who attended the Conference welcomed efforts by countries to set nationally defined national targets and timelines for enhancing national revenue, and agreed to support developing countries in need in reaching those targets. Countries committed themselves to improving the fairness, transparency, efficiency and effectiveness of their tax systems, including by broadening the tax base and strengthening tax administration. Countries also agreed to strengthen international cooperation to build capacity in developing countries, including through enhanced official development assistance (resolution 69/313, annex, para. 22).

9. In the Action Agenda, countries agreed to redouble efforts to substantially reduce illicit financial flows by 2030, with a view to eliminating them over time, including by combating tax evasion and corruption through strengthened national regulation and increased international cooperation. To help combat illicit financial flows, countries invited the International Monetary Fund (IMF), the World Bank and the United Nations to assist in this regard and for appropriate international institutions and regional organizations to publish estimates on the volume and composition of illicit financial flows. Moreover, Governments affirmed that they would strive to eliminate safe havens that create incentives for transfer abroad of stolen assets and illicit financial flows. Governments also agreed to strengthen regulatory frameworks to further increase transparency and accountability of the financial institutions and the corporate sector (resolution 69/313, annex, paras. 23-25).

10. Governments are committed to reducing opportunities for tax avoidance and to consider inserting anti-abuse clauses in all tax treaties. The Action Agenda also calls on companies to pay taxes to the Governments of countries where economic activity occurs and value is created (see resolution 69/313, annex, para. 23).

11. The Action Agenda recognizes the special challenge faced by countries relying on natural resource exports. In this respect, countries encouraged investment in value addition and processing of natural resources and productive diversification, and committed themselves to addressing excessive tax incentives in the extractive industries. In the Action Agenda, countries are encouraged to advocate to implement measures to ensure transparency, and take note of the Extractive Industries Transparency Initiative. Countries affirmed the need to continue sharing best practices and to promote peer learning and capacity-building for contract negotiations for fair and transparent concessions, revenue and royalty agreements and for monitoring the implementation of contracts (resolution 69/313, annex, para. 26).

12. Countries agreed to strengthen international cooperation in tax matters, including by adopting policies on country-by-country reporting by multinational

enterprises to tax authorities where they operate; ensuring access to beneficial ownership information for competent authorities; and progressively advancing towards automatic exchange of tax information among tax authorities as appropriate, with assistance to developing countries, especially the least developed, as needed. The Action Agenda notes that countries can engage in voluntary discussions on tax incentives in regional and international forums with a view to ending harmful tax practices (resolution 69/313, annex, para. 27).

13. The Action Agenda stresses that efforts in international tax cooperation should be universal in approach and scope and should fully take into account the different needs and capacities of all countries, and emphasizes the importance of inclusive cooperation and dialogue among national tax authorities. With regard to the work of the Committee of Experts on International Cooperation in Tax Matters, including its subcommittees, countries decided to further enhance its resources in order to strengthen its effectiveness and operational capacity. To that end, they committed themselves to increasing the frequency of its meetings to two sessions annually, with a duration of four working days each. The engagement of the Committee with the Economic and Social Council will be strengthened, including through the Council's Special Meeting on International Cooperation in Tax Matters, with a view to enhancing intergovernmental consideration of tax issues. The Action Agenda urges Member States to support the Committee and its subsidiary bodies through the voluntary trust fund, to enable the Committee to fulfil its mandate, including supporting the increased participation of developing country experts at subcommittee meetings. According to the Action Agenda, members of the Tax Committee shall continue to be appointed by the Secretary-General, in consultation with Member States (resolution 69/313, annex, paras. 28-29).

14. The importance of strengthening international tax cooperation and the work of the Tax Committee featured prominently in the plenary meetings (see A/CONF.227/CRP.1) and multi-stakeholder round tables[1] at the Third International Conference on Financing for Development. In addition, many side events focused on national resource mobilization and international tax cooperation.[2]

15. Recognizing the centrality of national resource mobilization, four major initiatives were launched at the Conference in the area of tax administration and international tax cooperation: a joint initiative of the Organization for Economic Cooperation and Development and the United Nations Development Programme on tax inspectors without borders; the Addis tax initiative, supported by over 30 countries and relevant international organizations; a joint initiative of the World Bank and IMF aimed at increasing the participation of developing countries in the international debate on tax rules and improving their diagnostic tax policy tools; and a new Asia-Pacific Tax Forum.

16. Following the adoption of the Action Agenda , the Permanent Representative of South Africa to the United Nations, speaking on behalf of the Group of 77 and China, highlighted some issues that were not adequately addressed in the Action

[1] The summaries of the round tables are available from www.un.org/esa/ffd/ffd3/documents.html.

[2] The full list of side events is available from www.un.org/esa/ffd/ffd3/wp-content/uploads/sites/2/2015/06/Draft-List-FfD3-Side-Events.pdf.

Agenda, including the need to fully upgrade the Tax Committee to an intergovernmental body.[3]

17. It will become clearer over time how the action items related to international cooperation in tax matters will be implemented, in particular how the work of the Committee of Experts will be strengthened and resourced, and how the process for selection of its members will function in the future.

[3] The statement of the Permanent Representative is available from www.un.org/esa/ffd/ffd3/wp-content/uploads/sites/2/2015/07/South-Africa-on-Behalf-of-G77-Closing.pdf.

United Nations E/C.18/2015/3

Economic and Social Council

Distr.: General
10 August 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh session
Geneva, 19-23 October 2015
Item 3 (a) (i) of the provisional agenda*
Application of treaty rules to hybrid entities

New provision for the United Nations Model Double Taxation Convention between Developed and Developing Countries to address the application of tax treaties to payments made through hybrid entities

Note by the Secretariat

Summary

The present note introduces the work undertaken by the Committee of Experts on International Cooperation in Tax Matters regarding a new provision for the United Nations Model Double Taxation Convention between Developed and Developing Countries to address the application of tax treaties to payments made through hybrid entities. Annex I contains the proposed changes to the United Nations Model and its commentary. Annex II provides examples to demonstrate the tax treaty issues that could arise in the context of payments made through a hybrid entity. Annex III contains extracts from the United States Model Technical Explanation for corresponding tax treaty provisions.

* E/C.18/2015/1.

15-13118 (E) 010915

Please recycle

I. Introduction

1. At the 2013 session of the Committee, Henry John Louie (United States) presented his country's approach to the application of the provisions of bilateral tax treaties to payments made through so-called hybrid entities. A hybrid entity, for this purpose, is an entity that two contracting States that are parties to a bilateral tax treaty characterize differently (e.g. an entity, such as a limited liability company, that one contracting State may view as a company and the other contracting State as fiscally transparent (for this purpose, an entity is treated as fiscally transparent if the character, source and timing of taxation of an item of income are unchanged when the item of income flows through the entity)). Mr. Louie explained that the following unintended outcomes may arise when applying a tax treaty to such payments: (a) double taxation because of the inappropriate denial of treaty benefits; (b) non-taxation because of the granting of treaty benefits in unintended cases, such as to third-country residents; or (c) the granting of treaty benefits at the inappropriate level (e.g. the granting of the lower withholding rate on dividends paid to companies when such dividends were derived by an individual shareholder).

2. The principles set out in the Organization for Economic Cooperation and Development (OECD) report entitled *The Application of the OECD Model Tax Convention to Partnerships* are aimed at preventing such unintended results. It has not proven to be the case, however, that all countries, in applying their tax treaties, implicitly recognize those principles. To the contrary, the position of many countries is that the report's outcomes cannot be obtained absent provisions in a tax treaty that explicitly provide for such results.

3. Mr. Louie described a provision that is found in United States bilateral income tax treaties. The Committee discussed the provision and concluded that further work should be done to incorporate such a provision, and thus the report's principles, into the United Nations Model. Mr. Louie observed that the OECD Working Party 1 on Tax Conventions and Related Questions had undertaken the same task in recent years and had made significant progress in drafting a new treaty provision and accompanying commentaries for the OECD Model.

4. While the provision found in United States tax treaty practice and the provision developed by Working Party 1 are broadly similar, the two provisions have some differences. After a discussion of those differences, the Committee concluded that the work on a possible new provision for the United Nations Model should be based on the OECD version. Mr. Louie offered to consult with the OECD secretariat and prepare a short paper for discussion at the 2014 session of the Committee that would incorporate into the United Nations Model the new provision for payments made through hybrid entities.

5. At the 2014 session, Mr. Louie presented a proposed new paragraph 2 of article 1 of the United Nations Model, as well as draft commentary in which the relevant portions of the new OECD Model commentary are quoted. During that meeting, some Committee members and representatives of Member States, including those of the Czech Republic, France and Slovakia, expressed the view that, with regard to payments made through entities located within a third State, the new provision should apply only if an exchange-of-information mechanism is in place between the State of source and the third country.

6. Mr. Louie acknowledged the concerns and explained that he was aware of existing variations of the proposed new paragraph 2 regarding payments made through entities located in third States that restrict the scope to entities located in States that have established an exchange-of-information mechanism with the source State. The Committee invited Mr. Louie to revise the proposed commentary to provide an alternative version of paragraph 2 that would employ such a narrower scope.

7. The Committee was invited to discuss the proposed changes to the United Nations Model and its commentary (see annex I) at its 2015 session.

Annex I

United Nations Model Double Taxation Convention between Developed and Developing Countries: proposed changes to address the application of tax treaties to payments made through hybrid entities

A. Replace article 1 of the Convention by the following (deletions from the existing text since the 2014 session are indicated by strikeout and additions by underlining):

Article 1
PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. In no case shall the provisions of this paragraph be construed so as to restrict in any way the right of a Contracting State to tax the residents of that State.

B. In the United Nations Model, add the following commentary on paragraph 2 of article 1, which includes changes to the existing commentary, in order to include the text of paragraphs 26.3 to 26.16 of the OECD Model (currently proposed as part of the OECD Base Erosion and Profit Shifting project). Paragraphs 1 to 3 of the commentary on article 1 remain unchanged. Other consequential changes to the commentary on article 1 would be required:

Paragraph 2

4. Paragraph 2 addresses special issues presented by payments to entities that are either wholly or partly fiscally transparent, such as partnerships and trusts. ~~The United Nations Model Convention does not contain special provisions relating to partnerships. The Contracting States are therefore left free to examine the problems concerning partnerships in bilateral negotiations and to agree upon such special provisions as the may find necessary and appropriate~~. The OECD Committee on Fiscal Affairs adopted in 1999 the report entitled "The application of the OECD Model Tax Convention to partnerships". The report deals with the application of the provisions of the OECD Model Tax Convention, and indirectly of bilateral tax conventions based on that Model, to partnerships. The Committee on Fiscal Affairs ~~recognized~~ recognizes, however, that many of the principles discussed in that report may also apply mutatis mutandis, to other non-corporate entities. In that report, references to "partnerships" cover entities which qualify as such under civil or commercial law as opposed to tax law. The wide differences in the views of the OECD member countries stem from the fact that their domestic laws treat partnerships in different ways. In some OECD countries,

partnerships are treated as taxable units and sometimes even as companies, while other OECD countries do not tax the partnership as such and only tax individual partners on their share of partnership income. Similar differences in the tax treatment of partnerships exist in the developing countries. The intent of paragraph 2 is to realize the principles set forth in the report.

5. An important question is whether a partnership should itself be allowed the benefits of the Convention. If, under the laws of a Contracting State, partnerships are taxable entities, a partnership may qualify as a resident of that Contracting State under paragraph 1 of Article 4 and therefore be entitled to the benefits of the Convention. However, if a partnership is treated as fiscally transparent under the laws of the residence State, and accordingly, the ~~a conduit and only~~ partners are taxed on the partnership's income, paragraph 2 provides that the provisions of the Convention should be applied at the level of the partners. ~~the partnership may be disregarded under the Convention, at least in the absence of special rules in the Convention providing otherwise.~~ These general principles are expanded upon in paragraphs 26.3 through 26.16 of the commentary on article 1 of the OECD Model Convention:

> 26.3 This paragraph addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes. The provisions of the paragraph ensure that income of such entities or arrangements is treated, for the purposes of the Convention, in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships".[3] That Report therefore, provides guidance and examples on how the provision should be interpreted and applied in various situations.
>
> 26.4 The Report, however, dealt exclusively with partnerships and while the Committee recognized that many of the principles included in the Report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the Model Tax Convention to these other entities at a later stage. As indicated in paragraph 37 of the Report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." According to the Report:
>
> > Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.
>
> 26.5 Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the Report.
>
> 26.6 The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are

[3] Reproduced in volume II of the full-length version of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention, p. R (15)-1.

not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents. The paragraph therefore confirms the conclusions of the Report in such a case (see, e.g., example 3 of the Report). Also, as recognised in the Report, States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

26.7 The following example illustrates the application of the paragraph:

> Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company, and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership, and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

26.8 The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 (a) of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. Also, as illustrated in example 2 of the Report, it does not matter where the entity or arrangement is established: the paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

26.9 The word "income" must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.

26.10 The concept of "fiscally transparent" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the

level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share, so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realization, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.[4] States wishing to clarify the definition of "fiscally transparent" in their bilateral conventions are free to include a definition of that term based on the above explanations.

26.11 In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph, while the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e., in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries while the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner's share of that income but is considered to be the income of the limited partnership as regards the limited partners' share of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State.

26.12 As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary, but must be accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary, but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends, even if both types of dividends are received within the same month.

26.13 By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant

[4] See paras. 37-40 of the Report.

income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention. Depending on the nature of the income, this will, therefore, allow the income to be considered, for example, as "income derived by" for the purposes of Articles 6, 13 and 17, "profits of an enterprise" for the purposes of Articles 7, 8 and 9 (see also paragraph 4.1 of the Commentary on Article 3) or dividends or interest "paid to" for the purposes of Articles 10 and 11. The fact that the income is considered to be derived by a resident of a Contracting State for the purposes of the Convention also means that, where the income constitutes a share of the income of an enterprise in which that resident holds a participation, such income shall be considered to be the income of an enterprise carried on by that resident (e.g., for the purposes of the definition of enterprise of a Contracting State in Article 3 and paragraph 2 of Article 21).

26.14 While the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.

26.15 The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterizes entities for the purposes of its domestic law. In the example in paragraph 26.7 above, while paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law.

26.16 The last sentence of the paragraph clarifies that the paragraph is not intended to restrict in any way a State's right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 above).[1] That sentence does not, however, restrict the obligation to provide relief of double taxation that is imposed on a Contracting State by Articles 23 A and 23 B where income of a resident of that State may be taxed by the other State in accordance w th the Convention, taking into account the application of the paragraph.

While as a general matter, the Committee is in agreement with paragraphs 26.3 to 26.16 of the commentary to article 1 of the OECD Model quoted above, some Committee members have expressed concerns about the application of paragraph 2 without any restrictions to payments made through entities located in third States. Those Committee members are of the view that the scope of paragraph 2 should be limited to situations in which the source State has in place an arrangement with the third State that permits the exchange of tax information. Such an arrangement could be a bilateral tax treaty or a tax information exchange agreement (including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters). Countries sharing the concerns of those Committee members may wish to adopt the following alternative version of paragraph 2:

2. For purposes of this Convention, income derived through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State, and that is formed or organized:

(a) in either Contracting State or

(b) in a State that has an agreement in force containing a provision for the exchange of information on tax matters with the Contracting State from which the income, profit, or gain is derived,

shall be considered to be income of a resident of a Contracting State, but only to the extent that the income is treated, for purposes of the taxation law of such Contracting State, as the income, profit or gain of a resident. In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.

6. ~~The application of the Convention to partnerships may also depend on the laws of the Contracting States. The laws of the Contracting States also determine the treatment under the Convention of a disposition of a partnership interest.~~

7. ~~If the Contracting States differ in their treatments of partnerships, different articles of the Convention can apply to the same transaction in the two States, which~~

[1] Para. 6.1 of the commentary to article 1 of the OECD Model Tax Convention states: "One issue is the effect that the application of the provisions of the Convention to a partnership can have on the taxation of the partners. Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some States may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State".

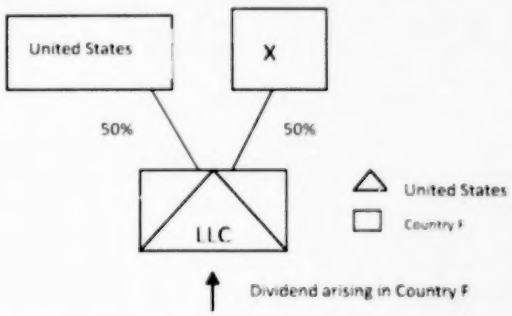
~~may result in double taxation or non-taxation in both States.~~ In response to a comment from a Committee member, Mr. Louie suggested changing the name of the article to "general scope", to more accurately reflect the coverage of the revised article. The Committee might wish to consider making that change in the next version of the Model.

Annex II

Examples of possible tax treaty issues arising in the context of payments made through a hybrid entity

The following examples are intended to demonstrate the possible tax treaty issues that could arise in the context of payments made through a hybrid entity.

Example 1: Payment arising in Country F (treaty partner) to Limited Liability Company, a United States of America entity that is treated by the United States as fiscally transparent.

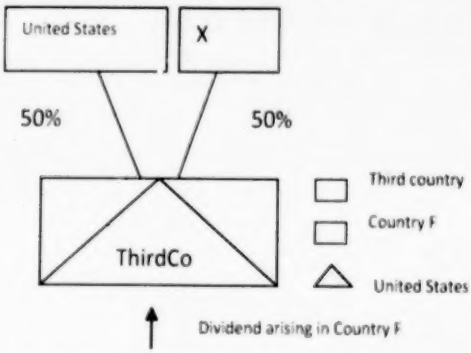


A limited liability company (LLC) organized in the United States and that is treated as fiscally transparent for United States tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats LLC as a corporation under its domestic law. LLC is equally owned by two corporate members, one resident in the United States and the other resident in Country X. Because of the United States treatment of LLC, the United States member is taxed currently by the United States on its 50 per cent share of the Country F dividend. This is the case even though Country F treats LLC as a corporation under its domestic law. It should follow that the United States member should be entitled to the benefits of the United States-Country F tax treaty (assuming that it satisfies any and all requirements set forth in the treaty). It should also follow that the portion of the dividend that flows through to the Country X member should not be entitled to the benefits of the United States-Country F tax treaty. However, as a policy matter, that dividend should be entitled to the benefits of the tax treaty between Country F and Country X, which is the other corporate member's State of residence.

While those desired outcomes are consistent with the principles of the report, countries may not apply their tax treaties in a manner that would reach those results absent an explicit treaty provision. Countries may argue, for instance, that since LLC is not taxed by the United States as a company, the dividend (which they see as being paid to LLC), is not entitled to treaty benefits because it is not being paid to a person that qualifies as a resident of the United States.

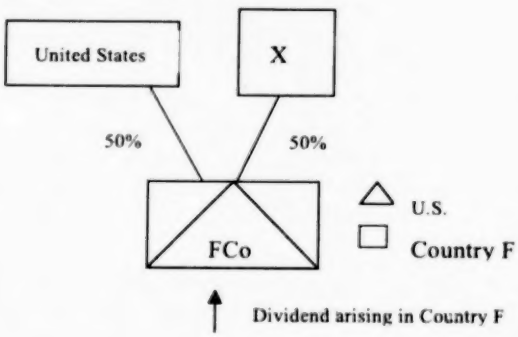
The example also raises the question of how to ensure that the appropriate level of treaty relief is be provided. For instance, if the United States member were an individual, as opposed to a company, it would seem appropriate that Country F apply the withholding rate available to portfolio dividends, as opposed to the rate available for direct dividends.

Example 2: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the United States.



ThirdCo is an entity organized in a third country. Both Country F (the source State) and the third country view ThirdCo as a company, but the United States views ThirdCo as fiscally transparent. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Even though Country F and the third country view ThirdCo as a company, because the United States, as the residence State, views ThirdCo as fiscally transparent (and thus, the United States member is taxed currently by the United States on its 50 per cent share of the Country F dividend), the United States member is treated as deriving 50 per cent of the dividend received by ThirdCo. From a policy perspective, the same outcomes should be reached in this example as in example 1.

Example 3: Payment arising in Country F to FCo, a Country F entity that is treated as fiscally transparent by the United States.

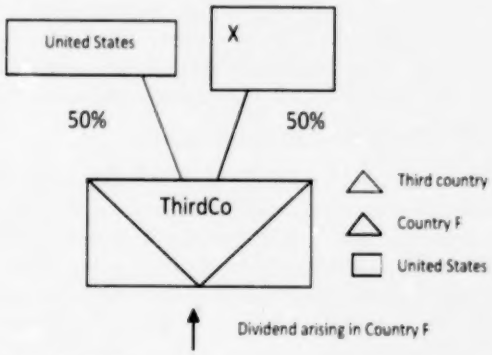


FCo, a company organized in Country F (the treaty partner) and treated as fiscally transparent for United States tax purposes, receives a dividend arising in the treaty partner, Country F. Country F treats FCo as a corporation under its domestic law. FCo is equally owned by two corporate members, one resident in the United States and the other resident in Country X.

This example is distinguishable from the previous examples because, from a Country F perspective, a Country F company is receiving a dividend arising in

Country F. It is therefore reasonable to assume that the United States-Country F tax treaty should not have application, and that Country F should be able to tax the dividend in accordance with its domestic law. Nevertheless, treaty benefits should be available with respect to any future dividends paid by FCo to the United States member.

Example 4: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the third country but as a company by the United States.



ThirdCo is an entity organized in a third country. Country F and the third country view ThirdCo as fiscally transparent, but the United States views ThirdCo as a company. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Because the United States, as the residence State, views ThirdCo as a company, the United States member is not taxed on a flow-through basis by the United States on its share of the Country F dividend. It should follow that the dividend arising in Country F should not be entitled to the benefits of the United States-Country F tax treaty.

Treaty provision

In order to provide clarity in such situations, the Committee may wish to consider adopting a rule into the United Nations Model. The following text is proposed for consideration:

> **For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.**

Additional treaty provisions

In order to achieve the desired result in example 3, it would be necessary to include in the Model, in addition to the above-mentioned draft provision, a provision that grants to a Contracting State the authority to tax its residents as if there were no Convention. Beyond achieving the desired result of example 3, such a provision would also be a valuable way of ensuring that residents of a Contracting State do not use a tax treaty to reduce the tax owed to that State by, for instance,

routing domestic source dividends through a company in the treaty partner. The following text is proposed for consideration:

[X.] Except to the extent provided in paragraph [Y], this Convention shall not affect the taxation by a Contracting State of its residents (as determined under article 4 (resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.

While as a general matter of policy, it should be the case that a Contracting State retains the right to tax its residents, there may be narrow instances in which a country may wish to provide certain treaty benefits to its own residents. The following provision provides a number of narrow exceptions to proposed paragraph [X]:

[Y.] The provisions of paragraph 4 shall not affect:

(a) The benefits conferred by a Contracting State under paragraph 2 of article 9 (associated enterprises), paragraph 7 of article 13 (gains), subparagraph (b) of paragraph 1, paragraphs 2, 3 and 6 of article 17 (pensions, social security, annuities, alimony and child support), paragraph 3 of article 18 (pension funds) and articles 23 (relief from double taxation), 24 (non-discrimination) and 25 (mutual agreement procedure); or

(b) The benefits conferred by a Contracting State under paragraph 1 of article 18 (pension funds), articles 19 (government service), 20 (students and trainees) and 27 (members of diplomatic missions and consular posts) upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

Annex III

Extracts from the United States Model Technical Explanation for corresponding tax treaty provisions[a]

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. income tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided under their domestic laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the other Contracting State performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the other Contracting State is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894 (a)). Subparagraph 5(a) of Article 1 also preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the other Contracting State. See paragraph 4 of Article 23 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of the other Contracting State under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its domestic law to that person to the extent that its law is inconsistent with the Convention.

However, the person would still be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, each Contracting State also reserves its right to tax former citizens and former long-term residents in accordance with domestic law. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if he fails to certify that he has complied with U.S. tax laws during the 5 preceding years, or if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status; or (b) the net worth of such individual as of the date of the loss of status.

[a] Secretariat note: the text of annex III is based not only on the 2006 United States Model Income Tax Convention, but also on current United States views and practice. A new version of the United States Model Technical Explanation, which will reflect such views and practice, is currently proposed.

The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of the other Contracting State under this Convention, or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

Paragraph 5

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under domestic law.

Subparagraph 5 (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraph 7 of Article 13 (Gains) coordinates the tax systems of the Contracting States to avoid double taxation that could result from the imposition of an exit tax or similar regime on an individual who ceases to be treated as a resident (as determined under paragraph 1 of Article 4 (Resident)) of on Contracting State and becomes a resident of the other Contracting State.

(3) Subparagraph 1 (b), paragraphs 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(4) Paragraph 3 of Article 18 (Pensions Funds) provides an exemption for certain investment income of pension funds located in the other Contracting State.

(5) Article 23 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(6) Article 24 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory taxation practices in the other Contracting State.

(7) Article 25 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition. The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph 5 (b) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (e.g., in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are: the host country exemptions for government service salaries and pensions under Article 19 (Government Service), certain income of visiting students and trainees under Article 20 (Students and Trainees) and the income of diplomatic agents and consular officers under Article 27 (Members of Diplomatic Missions and Consular Posts); and the beneficial tax treatment of pension fund contributions under paragraph 1 of Article 18 (Pension Funds).

Paragraph 6

Paragraph 6 addresses special issues presented by the payment of items of income, profit or gain to entities that are either wholly or partly fiscally transparent, such as partnerships, estates and trusts. Because countries may take different views as to when an entity is wholly or partly fiscally transparent, the risk of both double taxation and double non-taxation is relatively high. The provision, and the corresponding requirements of the substantive rules of the other Articles of the Convention, should be read with two goals in mind. The intention of paragraph 6 is to eliminate a number of technical problems that could prevent investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents a resident of a Contracting State from claiming treaty benefits in circumstances where the resident investing in the entity does not take into account the item of income paid to the entity because the entity is not fiscally transparent in its State of residence.

In general, the principles incorporated in this paragraph reflect the regulations under Treas. Reg. section 1.894-1(d). Treas. Reg. 1.894-1(d) (3)(iii) provides that an entity will be fiscally transparent under the laws of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly by the interest holder. Entities falling under this description in the United States include partnerships, corporations that have made a valid election to be taxed under Subchapter S of Chapter 1 of the Code ("S corporations"), common investment trusts under section 584, simple trusts and grantor trusts. This paragraph also applies to payments made to other entities, such as U.S. limited liability companies ("LLCs"), that may be treated as either partnerships or as disregarded entities for U.S. tax purposes. Entities falling under this description in the other Contracting State include _____.

Under paragraph 6, an item of income, profit or gain derived by or through such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. Where the entity is a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit under the Convention for the interest paid to the partnership, because such third-country partners are not residents of the United States for purposes of claiming this benefit. If, however, the country in which the third-country partners are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the other Contracting State, they may be entitled to claim a benefit under that convention (these results would also follow in the case of an entity that is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single-owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes under the laws of the other Contracting State. In contrast, where the entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a company that is a resident of the other Contracting State to the U.S. corporation will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result would be reached even if the tax laws of the other Contracting State would treat the entity differently (e.g., if the entity were not treated as fiscally transparent in the source State in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The outcome would be identical regardless of where the entity is organized (i.e., in the United States, in the other Contracting State or, as noted above, in a third country), subject to the saving clause of paragraph 4.

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of the other Contracting State as a corporation and is owned by a shareholder who is a resident of the other Contracting State for its tax purposes is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

These principles also apply to trusts to the extent that they are wholly or partly fiscally transparent in either Contracting State. For example, suppose that X, a resident of the other Contracting State, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust. If, under the laws of the other Contracting State, X is treated as taking the trust's income into account for tax purposes, the trust's income would be regarded as being

derived by a resident of the other Contracting State. In contrast, since the determination of deriving an item of income, profit or gain is made on an item by item basis, it is possible that, in the case of a U.S. non-grantor trust, the trust itself may be able to claim benefits with respect to certain items of income, such as capital gains, so long as it is a resident liable to tax on such gains, but not with respect to other items of income that are treated as income of the trust's interest holders.

As noted above, paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with members who are residents of the other Contracting State elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the other Contracting State views the LLC as fiscally transparent.

United Nations E/C.18/2015/4

Economic and Social Council

Distr.: General
10 August 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh session
Geneva, 19-23 October 2015
Item 3 (b) (v) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

The paper contained in the annex to the present note was prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, UCLA School of Law, at the request of the Financing for Development Office of the Department of Economic and Social Affairs of the United Nations Secretariat, pursuant to Economic and Social Council resolutions 2014/12 and 2013/24. In those resolutions, the Council recognized the progress made by the Office in its work in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities.

One of the current areas of focus of the above-mentioned programme is on strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization through enhancing their ability to effectively protect and broaden the tax base. Wasteful tax incentives have been identified by developing countries as major contributor to tax base erosion. The paper aims to provide developing countries with an overview of key concepts and issues regarding tax incentives and their use to attract investment.

* E/C.18/2015/1.

15-13121 (E) 010915

Please recycle

Annex

Tax incentives: an overview of key concepts and issues*

I. Introduction

1. The present paper seeks to provide an overview of key concepts and issues regarding tax incentives and their use to attract investment.[1] Some contend that tax incentives, particularly for foreign direct investment, are bad in both theory and in practice. Tax incentives are bad in theory because they distort investment decisions. Tax incentives are bad in practice because they are often ineffective, inefficient and prone to abuse and corruption.

2. Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization world, developed countries also adopt tax regimes that favour export activities and seek to provide their resident corporations a competitive advantage in the global marketplace. Many transition and developing countries have an additional focus. Tax incentives are used to encourage domestic industries and to attract foreign investment. Here, the tools of choice are often tax holidays, regional investment incentives, special enterprise zones and reinvestment incentives.

3. Much has been written about the desirability of using tax incentives to attract new investment. The United Nations,[2] the International Monetary Fund (IMF),[3] the Organization for Economic Cooperation and Development (OECD)[4] and the World

---

* Prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, UCLA School of Law.

[1] Parts of the discussion in the present paper rely on Alex Easson and Eric M. Zolt, "Tax Incentives", World Bank Institute (Washington, D.C., World Bank Group, 2002), available from http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

[2] See, for example, United Nations Conference on Trade and Development, *Incentives and Foreign Direct Investment* (United Nations publication, Sales No. E.96.II.A.6); and *Tax Incentives and Foreign Direct Investment: A Global Survey* (United Nations publication, Sales No. E.01.II.D.5).

[3] See, for example, George E. Lent, "Tax Incentives for Investment in Developing Countries", *IMF Staff Papers*, vol. 14, No. 2 (Washington, D.C., IMF, 1967); Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries", International Monetary Fund (Washington, D.C., IMF, 2001); Alexander Klemm, "Causes, Benefits and Risks of Business Tax Incentives", International Monetary Fund (Washington, D.C., IMF, 2009); and David Holland and Richard J. Vann, "Income Tax Incentives for Investment", in *Tax Law Design and Drafting* , Victor Thuronyi, ed., vol. 2 (Washington, D.C., IMF, 1998).

[4] See, for example, Organization for Economic Cooperation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Study No. 17 (2007); Organization for Economic Cooperation and Development, "Tax Incentives for Investment: A Global Perspective: experiences in MENA and non-MENA countries", in *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda* (Paris: OECD, 2008).

Bank[5] have produced useful reports that provide guidance to policymakers on whether to adopt tax incentives and how best to design them. The empirical evidence on the cost-effectiveness of using tax incentives to increase investment is inconclusive. While economists have made significant advances in determining the correlation between increased tax incentives and increased investment, it is challenging to determine whether tax incentives caused the additional investments. This is partly because it is difficult to determine the amount of marginal investment associated with the tax benefit; that is to say, the investments that would not otherwise have occurred "but for" the tax benefits. While foreign investors often claim that tax incentives were necessary for the investment decision, it is not easy to determine the validity of the claim. Governments often adopt tax incentives in a package with other reforms designed to improve the climate for investment, making it difficult to determine the portion of new investment that is attributable to tax benefits and the portion that relates to other pro-investor reforms. With these qualifications, it is sometimes easy to conclude that a particular tax incentive scheme has resulted in little new investment, with a substantial cost to the government. In other cases, however, tax incentives have clearly played an important role in attracting new investment that contributed to substantial increases in growth and development.

4. One place to start thinking about tax incentives is to consider what role governments should play in encouraging growth and development. Governments have many social and economic objectives and a variety of tools to achieve those objectives.[6] Tax policy is just one option, and taxes are just one part of a complex decision as to where to make new domestic investment or commit foreign investment. Governments have a greater role than to focus on relative effective tax burdens. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment, rather than simply doling out tax benefits. Thus, while much of the focus on tax incentives is on the taxes imposed by government, it is also important to examine the government spending side of the equation. Investors, both domestic and foreign, benefit from government expenditures. A comparison of relative tax burdens requires consideration of relative benefits from government services.

[5] See, for example, Robin W. Boadway and Anwar Shah, "Perspectives on the Role of Investment Incentives in Developing Countries", World Bank (Washington, D.C.), World Bank, 1992); Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2013); Sebastian James, "Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2009); and Alex Easson and Eric M. Zolt, "Tax Incentives", World Bank Institute (Washington, D.C., World Bank Group, 2002), available from http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

[6] See, generally, Richard M. Bird and Eric M. Zolt, "Tax Policy in Emerging Countries", in *Environment and Planning C: Government and Policy*, vol. 26 (UCLA School of Law, 2008); Richard M. Bird, "Tax Incentives for Investment in Developing Countries", in *Fiscal Reform and Structural Change in Developing Countries*, Guillermo Perry, John Whalley and Gary McMahon, eds., vol. 1 (London: Canada: Macmillan in association with the International Development Research Centre, 2000).

II. Definition of tax incentives

5. At one level, tax incentives are easy to identify. They are those special provisions that allow for exclusions, credits, preferential tax rates or deferral of tax liability. Tax incentives can take many forms: tax holidays for a limited duration, current deductibility for certain types of expenditures or reduced import tariffs or customs duties. At another level, it can be difficult to distinguish between provisions considered part of the general tax structure and those that provide special treatment. This distinction will become more important when countries become limited in their ability to adopt targeted tax incentives. For example, a country can provide a 10 per cent corporate tax rate for income from manufacturing. This low tax rate can be considered simply an attractive feature of the general tax structure as it applies to all taxpayers (domestic and foreign) or it can be seen as a special tax incentive (restricted to manufacturing) in the context of the entire tax system.

6. Tax incentives can also be defined in terms of their effect on reducing the effective tax burden for a specific project.[7] This approach compares the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

7. Commentators contend tax incentives may now play a larger role in influencing investment decisions than in past years. Several factors explain why tax considerations may have become more important in investment decisions.[8] First, tax incentives may be more generous now than in past years. The effective reduction in tax burden for investment projects may be greater than in the past, as tax holiday periods increase from 2 years to 10 years or the tax relief provided in certain enterprise zones comes to include trade taxes as well as income taxes. Second, over the past several decades there has been substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor in investment decisions increases. Third, business has changed in many ways. Firms have made major changes in organizational structure, production and distribution methods and the types of products being manufactured and sold. Highly mobile services and intangibles are a much higher portion of cross-border transactions than in past years.

8. Fewer firms now produce their products entirely in one country. Many of them contract out to third parties (either unrelated third parties or related "contract manufacturers") some or all of their production. With improvements in transportation and communication, component parts are often produced in multiple countries, which results in increased competition for production among several countries. In addition, distribution arrangements have evolved, where the functions and risks within a related group of corporations are allocated to reduce tax liability through so-called commissionaire arrangements. Finally, there has been substantial growth in common markets, customs unions and free trade areas. Firms can now

[7] See Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries", International Monetary Fund (Washington, D.C., IMF, 2001).

[8] See Alex Easson, "Tax Incentives for Foreign Investment, Part I: Recent Trends and Countertrends", *Bulletin for International Fiscal Documentation*, vol. 55. (2001).

supply several national markets from a single location. This will likely encourage competition among countries within a common area to serve as the host country for firms servicing the entire area.

9. While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. In some countries, tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage compared with other countries. It makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime closer to international practice, rather than grant favourable tax treatment to specific investors. Similarly, tax incentives are a poor response to the economic or political problems that may exist in a country. If a country has inadequate protection of property rights, rigid employment laws or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than provide investors with additional tax benefits.

10. The effectiveness of tax incentives is directly related to the investment climate (including investor confidence that a revenue authority will actually honour tax incentives without controversy) in a particular country.[9] While two countries could provide identical tax incentives (for example, a 10-year holiday for corporate income taxes), the relative effectiveness of the incentive in attracting foreign direct investment is substantially greater for the country with the better investment climate.[10]

III. Different types of tax competition

11. Tax incentives are all about tax competition — how can a country attract investment that otherwise would have gone to a different region or country? Countries may seek to compete for different types of investments, such as headquarters and service businesses, mobile light assembly plants or automobile manufacturing facilities. The starting point in thinking about tax competition is to consider the reasons why foreign investors invest in a particular country. At a highly stylized general level, there are three primary reasons to engage in cross-border investments: (a) to exploit natural resources; (b) to facilitate the selling or production of goods or services in a particular market; and (c) to take advantage of favourable conditions in a particular country (such as relatively low wages for qualified workers) to produce goods for export (either as finished products or as components). The competition for foreign investment will differ depending on the reason for the investment. For example, tax competition will exist among countries of a common

[9] See Stefan Van Parys and Sebastian James, "Why Tax Incentives May be an Ineffective Tool to Encouraging Investment? — The Role of Investment Climate", International Monetary Fund, World Bank Group (Washington, D.C., IMF; World Bank Group, 2009), available from http://ssrn.com/abstract=1568296.

[10] See Sebastian James, "Providing Incentives for Investment: Advice for Policymakers in Developing Countries", Investment Climate in Practice, No. 7, World Bank Group (Washington, D.C., World Bank Group, 2010). He estimates that tax incentives in a country with a good investment climate may be eight times more effective in attracting foreign investment than in countries with less favourable investment environments.

customs union for the manufacturing or distribution facility that will service the entire region. In contrast, for export platforms, the competition will be among countries that have similar comparative advantages. As such, the competition for investment may be global, among countries in a particular region or even among States within a particular country. The key point is that the design and the effectiveness of tax incentives will differ depending on the type of investment.

IV. Additional investment incentives

12. Countries will compete for foreign investment using any means available to them. Non-tax incentives, such as training grants, low-cost loans or infrastructure improvements can be substitutes or complements to tax incentives. If challenges exist to using tax incentives (for example, due to agreements not to use particular types of tax incentives or because of the structure of the tax regime in the foreign investor's home country), then countries will likely make greater use of non-tax incentives.

13. A different form of investment incentives is tax-related, but not generally included in the list of types of tax incentives. These disguised tax incentives can include liberal safe harbours in transfer pricing rules, provisions that facilitate aggressive tax planning and even tacit forms of lax tax enforcement. For example, the United States "check-the-box" regulations can be viewed as a tax incentive to allow United States multinational entities to compete more effectively with non-United States multinational entities by using hybrid entities to minimize foreign tax liability in high-tax countries.

V. Role of non-tax factors

14. Deciding whether and where to invest is a complex decision. It is not surprising that tax considerations are just one factor in these decisions. Commentators have listed several factors that influence investment decisions, particularly those of foreign investors.[11] A partial list of these factors is set forth in the box below.

Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.
5. Skilled labour force and flexible labour code governing employer and employee relations.
6. Availability of adequate dispute resolution mechanisms.
7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets — size and efficiency.

[11] Sebastian James, "Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2009).

15. Most surveys of business executives conclude that taxes were often not a major consideration in deciding whether and where to invest. For most types of investments, there is a two-part decision. First, from a business perspective, which country would be the best choice for achieving a particular investment objective? Second, from a tax perspective, how would activities be structured to minimize tax liabilities (both on a country basis and an aggregate worldwide basis)?

VI. Review of empirical evidence

16. Several economic studies have examined the effect of taxes on investment, particularly foreign direct investment. While it is not easy to compare the results of different empirical studies, scholars have attempted to survey the various studies and to reach some conclusions as regards the effect of taxes on levels of foreign investment.[12] Such surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies and limitations.[12] The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

17. Part of the difficulty in determining the effect of taxes on foreign investment is getting a good understanding of the different types of foreign investment and the different sources of funding for foreign investment. Foreign investment consists of both portfolio and direct investment. While different ways to distinguish portfolio and direct investment exist, a common approach is to focus on the foreign investor's percentage ownership of the domestic enterprise. For example, if the foreign investor owns a greater than 10 per cent stake in an enterprise, the investment is likely more than a mere passive holding for investment purposes. Foreign direct investment can be further divided into direct transfers from a parent company to a foreign affiliate through debt or equity contributions and reinvested earnings by the foreign affiliate.

18. The different forms of foreign investment are also important, as each form may respond differently to taxes. Types of foreign investment include: (a) real investments in plant and equipment; (b) financial flows associated with mergers and acquisitions; (c) increased investment in foreign affiliates; and (d) joint ventures. Finally, commentators have noted that taxes may affect a decision as to the source of financing more than decisions as to the level of investment.[13] Investors have several alternatives on how to fund new ventures or expand existing operations.

---

[12] See Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* (Brussels, Office for Official Publications of the European Communities, 1992); see also James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," in *Fiscal Policy: Lessons from Economic Research* (Cambridge, Massachusetts: MIT Press, 1997), Alan Auerbach, ed., and James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation", *National Tax Journal*, vol. 52 (1999); Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research", *International Tax and Public Finance*, vol. 10, No. 6 (2003); and Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives", International Monetary Fund (Washington, D.C., IMF, 2009).

[13] See Alan Auerbach, "The Cost of Capital and Investment in Developing Countries", in *Fiscal Incentives for Investment and Innovation*, Anwar Shah, ed., vol. 1 (Washington, D.C., World Bank Group, 1995).

Taxes likely play a role in the choice of whether to make a new equity investment, use internal or external borrowing or use retained earnings to finance investments.

19. When the results of tax incentive regimes are examined seriously, there are successes and failures.[14] A good review of the results of incentives is set forth in a 1996 United Nations study.[2] The United Nations study concluded that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile."[2] OECD reached a similar conclusion in finding that host country taxation affects investment flows and that it is an increasingly important factor in locational decisions.[15]

---

[14] See Ngee Choon Chia and John Whalley, "Patterns in Investment Tax Incentives Among Developing Countries", in *Fiscal Incentives for Investment in Developing Countries*, Anwar Shah, ed. (Washington, D.C., World Bank, 1992).

[15] See W. Steven Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options", *Canadian Tax Journal*, vol. 48 (2000).

United Nations E/C.18/2015/5

Economic and Social Council

Distr.: General
10 August 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh session
Geneva, 19-23 October 2015
Item 3 (b) (v) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

1. The paper contained in the annex to the present note was prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, University of California Los Angeles School of Law, at the request of the Financing for Development Office of the Department of Economic and Social Affairs of the Secretariat, pursuant to Economic and Social Council resolutions 2013/24 and 2014/12. In those resolutions, the Council recognized the progress made by the Office in its work in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and national tax authorities in developing countries to develop more effective and efficient tax systems that support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in that area and to further develop its activities.

2. One of the current areas of focus of the capacity development programme is on strengthening the capacity of developing countries to increase their potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. Tax incentives are used by Governments to attract new investment. In some cases, tax incentives have played an important role in attracting new investment that has contributed to substantial increases in growth and development. In other cases, however, tax incentive regimes have resulted in little new investment, with substantial tax base erosion. The paper annexed hereto examines the benefits and costs of using tax incentives and addresses issues in designing, granting and administering them.

* E/C.18/2015/1.

15-13122 (E) 280815

Please recycle

Annex

Tax incentives: benefits and costs, design and administrative considerations*

I. Introduction

1. The present paper examines the benefits and costs of using tax incentives and important considerations for designing, granting and monitoring the use of tax incentives to increase investment and growth. Tax incentives are often criticized on the grounds that they erode the tax base without any substantial effects on the level of investment. It is not easy to separate criticism of the tax incentive regimes that are currently in place from criticism of all tax incentives. Tax experts have recognized that certain well-designed tax incentives have been successful in increasing investment.

II. Benefits and costs of tax incentives

A. Benefits of tax incentives

2. If properly designed and implemented, tax incentives are a useful tool for attracting investments that would not have been made without the provision of tax benefits. Tax incentives are justified if they correct market inefficiencies or generate positive externalities. Scholars view such tax incentives as desirable, given that, without government intervention, the level of foreign direct investment would be suboptimal.[1]

3. It is not surprising that Governments often choose tax incentives over other types of action. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in a country. In addition, tax incentives do not require an expenditure of funds by the Government as do some alternatives, such as the provision of grants or cash subsidies to investors. Although tax incentives and cash grants may be similar in terms of their economic cost to Governments, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

4. New foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. A well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable costs compared with the benefits received. The types of benefits from tax incentives for foreign investment are the benefits commonly associated with foreign direct investment, including increased capital, knowledge and technology transfers, increased employment and assistance in improving conditions in less developed areas.

5. Foreign direct investment may generate substantial spillover effects. For example, the choice of location for a large manufacturing facility will not only result

---

* Prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, University of California Los Angeles School of Law.

[1] Yoram Y. Margalioth, "Tax competition, foreign direct investments and growth: using the tax system to promote developing countries", *Virginia Tax Review*, vol. 23, issue 1 (2003).

in increased investment and employment in that facility but also in firms that supply and distribute the products emanating from it. Economic growth will increase the spending power of the country's residents and that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor, such as taxes paid after the expiration of the tax holiday period, or indirectly through increased tax revenue received from employees, suppliers and consumers.

6. The positive view of the benefits of foreign direct investment has recently been challenged by those who question whether tax incentives actually increase the level of foreign direct investment and whether foreign direct investment actually generates economic growth that is beneficial to development.[2] In this view, even if tax incentives succeed in attracting new investment, it is not clear, with many types of foreign investments, whether the developing country benefits.

7. Although a general description can be provided of the possible types of benefits from the additional investment that results from tax incentives, it is difficult to quantify them with any degree of certainty and, at times, benefits accrue to persons other than the firm receiving the tax benefits.

B. Costs of tax incentives

8. In considering the costs of a tax incentive regime, it may be useful to examine four different types of costs: (a) revenue costs; (b) resource allocation costs; (c) enforcement and compliance costs; and (d) the costs associated with corruption and lack of transparency.[3]

Revenue costs

9. The tax revenue losses from tax incentives come from two primary sources: forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives and lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those qualifying for favourable tax treatment.

10. Policymakers seek to target tax incentives to achieve the greatest possible benefits for the lowest cost. The ideal scenario would be to offer tax incentives only to those investors at the margin who would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit merely results in a transfer to the investor from the host Government without any gain. It is very difficult to determine on a project-by-project basis which ones were undertaken solely due to tax incentives, much as it is difficult to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

11. For those projects that would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. To the extent that the firms

[2] Yariv Brauner, "The future of tax incentives for developing countries", in *Tax, Law and Development*, Yariv Brauner and Miranda Stewart, eds. (Cheltenham, United Kingdom of Great Britain and Northern Ireland, Edward Elgar Publishing, 2014).

[3] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax incentives for business investment: a primer for policymakers in developing countries", *World Development*, vol. 30, No. 9 (2002).

become regular taxpayers or that their operations generate other tax revenue, such as increased profits from suppliers or increased wage taxes from employees, there are revenue gains from those projects.

12. An additional revenue cost of tax incentives results from the erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result when taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are available only to foreign investors, local firms or individuals can route their local investments through foreign corporations; or if tax benefits are available only to new firms, taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

13. Other leakages occur when taxpayers use tax incentives to reduce their tax liability from non-qualified activities. For example, when a firm qualifies for a tax holiday because it is engaged in a type of activity that the Government believes merits tax incentives, it is likely quite difficult to monitor the firm's operation to ensure that it does not engage in additional non-qualifying activities. Even for cases in which the activities are separated, it is very difficult to monitor related-party transactions to make sure that income is not shifted from a taxable firm to a related one that qualifies for a tax holiday.

Resource allocation costs

14. If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. On the one hand, the additional investment will occasionally correct for market failures; on the other hand, the tax incentives may cause allocation of resources that could result in too much investment in certain activities or too little investment in other non-tax favoured areas.

15. It is difficult to determine the effects of tax provisions in countries where markets are relatively developed. It is even more difficult to determine the consequences of tax provisions in developing countries where the markets do not reflect the existing competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[4]

Enforcement and compliance costs

16. As with any tax provision, there are resource costs incurred by the Government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive and the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The greater the complexity of the tax incentive regime, the higher the potential enforcement and compliance costs. Tax incentive schemes that have many beneficiaries are also more difficult to enforce than narrowly targeted regimes.

[4] Richard George Lipsey and Kelvin Lancaster, "The general theory of second best", *Review of Economic Studies*, vol. 24, No. 1 (1956-1957).

17. It is difficult to motivate revenue authorities to spend resources monitoring tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection, so it is not surprising that they prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement.

Costs associated with corruption and lack of transparency

18. Corruption can constitute a major barrier to foreign investment in a country but it does not, however, prevent foreign investors from benefiting from a corrupt system. In recent years, scholars have focused on the corruption and other rent-seeking behaviour associated with the granting of tax incentives. Several different policy approaches exist for designing the qualification requirements for tax incentives. Policymakers can choose between approaches that are automatic and objective or those that are discretionary and subjective. The opportunity for corruption is much greater for tax incentive regimes in which officials have a large amount of discretion in determining which investors or projects receive favourable treatment. The potential for abuse is also greater in cases in which no clear guidelines exist for qualification.

19. The International Monetary Fund, the Organization for Economic Cooperation and Development (OECD) and the World Bank have projects that try to reduce corruption and provide assistance to countries to establish anti-corruption programmes.[5] One element of such programmes should be the monitoring of foreign investment projects and particularly the granting of investment incentives. If a tax incentive is found to have been improperly obtained, the attendant privileges should be withdrawn and any tax that has been avoided should be repaid, in addition to any other legal sanctions.

Estimates of the costs of tax incentives

20. Even when tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefits derived from the new investment. This is difficult to substantiate, since problems exist with regard to estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost in terms of forgone revenue and/or direct financial subsidies for each job created. Studies using that approach may not provide a true measure of efficiency, because they measure only the cost, and not the value, of the jobs created. The cost of jobs varies widely according to the country and the industrial sector, and the more "expensive" jobs may bring with them greater spillover benefits, such as technology transfer.

21. All revenue estimates are based on a set of assumptions about the responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objectives are to determine the amount of incremental

[5] See Organization for Economic Cooperation and Development (OECD), United Nations Office on Drugs and Crime and World Bank, Anti-Corruption Ethics and Compliance Handbook for Business; Asian Development Bank and OECD, Anti-Corruption Initiative for Asia and the Pacific. Available from www.oecd.org/site/adboecdanti-corruptioninitiative; Vito Tanzi, "Corruption around the world: causes, consequences, scope and cures", *Staff Papers, International Monetary Fund*, vol. 45, No. 4 (December 1998).

investment resulting from tax incentives and the costs and benefits associated with attracting that investment.

22. Those objectives require that assumptions be made about: (a) the amount of investment that would have been made without the tax incentive programme; (b) the amount of leakage from the tax base due to taxpayers improperly claiming the tax incentives or shifting income from taxable to related tax-exempt or lower-taxed entities; and (c) the tax revenue gained from the activities, undertaken after the incentive expires, of taxpayers who were granted a tax incentive or from those activities generating other sources of tax revenue.

23. Two methods for increasing the accountability and transparency of tax incentives are implementing tax incentive budgets and analysing general tax expenditure. As discussed below, in many countries the tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. In those countries, different government agencies, such as foreign investment agencies or ministries of economy, have a role in designing investment regimes, approving projects and monitoring investments. Their major objective is to attract investments; they are often less concerned with protecting the tax base.

24. An approach that merits consideration is setting a target monetary amount of tax benefits to be granted under a tax incentive regime, which would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

25. Another method is to include tax incentives in a formal tax expenditure budget. All OECD countries and several other countries require estimates to be prepared on the revenue impact of certain existing and proposed tax provisions. The goal of those budgets is to highlight the consequences for revenue of providing tax benefits. That approach seeks to treat tax expenditure in a manner similar to direct spending programmes and thus effectively equates direct spending by the Government with indirect spending by the Government through the tax system. Although the scope of tax expenditure analysis goes beyond tax incentives, countries can choose to follow this approach for only certain types of tax incentives or for a broader class of tax provisions. For those countries that do not have a formal tax expenditure requirement, it is advised that they undertake the exercise to decide whether to adopt or retain a tax incentive regime.[6]

III. Design considerations for tax incentives

A. Eligibility issues

26. Tax incentives are departures from the benchmark system that are granted only to those investors or investments that satisfy prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. The first question to answer when designing a tax incentive system is what types of investment the incentives are intended to attract.

[6] Sebastian James, "Effectiveness of tax and non-tax incentives and investments: evidence and policy implications" (Washington, D.C., World Bank Group, September 2013).

Targeting incentives

27. Incentives may be broadly targeted, aiming at all new investment, foreign or domestic, or they may be very narrowly targeted, designed for one particular proposed investment. The targeting of incentives serves two important purposes: (a) it identifies the types of investment that host Governments seek to attract; and (b) it reduces the cost of incentives because it reduces the number of investors that benefit.

28. The concept of targeting incentives raises the questions of whether a Government should treat some types of investment as more desirable or beneficial than others; and whether a Government should seek to attract tax incentives and target them at particular types of investments or decide that investment decisions should be left solely to market forces. Justifiable doubt exists about the ability of politicians to choose winning investors, particularly in countries where markets are less than perfect. Furthermore, there are some types of investment that, although not completely prohibited, may not deserve encouragement in the form of tax benefits. In the ideal scenario, incentives would be given only for incremental investment, that is, for investments that would not otherwise have occurred but for the tax benefits.

29. An initial question is whether the granting of tax incentives should be discretionary or automatic, once the prescribed conditions are met. In many cases it may be advisable to limit discretion, but if qualification for incentives is made largely automatic, it would be necessary for the qualifying conditions to be elaborated clearly and in detail.

30. Many countries grant preferential tax treatment to certain sectors of the economy or to certain types of activities. Sectoral targeting has many advantages, such as restricting the benefits of the incentives to those types of investment that policymakers consider to be most desirable and making it possible to target those sectors that are most likely to be influenced by tax considerations. Among the sectors of the economy and types of activities commonly preferred are manufacturing activities and pioneer industries, as well as export promotion, locational incentives and investments that result in significant transfers of technology.

31. Countries may elect to restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment, which is the case in China and Ireland. Such preferential treatment may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its potential to create employment, or a view that certain services tend to be more market-driven and therefore less likely to be influenced by tax considerations.

32. Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy. Those countries can restrict tax incentives to pioneer enterprises. To be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically or engage in other specified activities that are not being performed by domestic firms yet are considered especially beneficial to the host country.

33. Many countries provide tax incentives to locate investments in particular areas or regions within the country. The incentives may be provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central Government, often as part of its regional development policy, to promote investment in less developed regions of the country or in areas of high unemployment.

34. One benefit of foreign direct investment is the creation of new employment opportunities and, not surprisingly, incentives are frequently provided with the express intent of encouraging job creation. Policymakers could provide for tax incentives for investment in regions of high unemployment or tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs as a qualifying condition for the tax holiday or other incentive.

35. Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that they may be useful for promoting activities such as research and development, if only as a way to correct market imperfections. Countries attempt to attract technologically advanced investment in several ways: (a) by targeting incentives at technologically advanced sectors; (b) by providing incentives for the acquisition of technologically advanced equipment; and (c) by providing incentives for carrying out research and development activities.

36. The experience of many developing countries is that export promotion and the attraction of export-oriented investment is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Incentives targeted specifically at export-oriented investment may be more effective than other tax incentives, due to the higher degree of mobility of such investment.

Forms of tax incentives

37. The present paper examines three different types of tax incentives: tax holidays, investment credits and allowances, and tax credit accounts. Whereas the first two types of incentives are used frequently, the tax credit account approach has received too little attention from policymakers. Designing tax incentives requires a determination of the types of investment that qualify and the form of tax incentive to adopt. Tax incentives for investment take a variety of forms, the most common of which are set out in the table below.

Tax incentives worldwide

	Number of countries surveyed	*Tax holiday tax exemption*	*Reduced tax rate*	*Investment allowance tax credit*	*VAT exemption reduction*	*Research and development tax incentive*	*Super deductions**	*SEZ free zones EPZ free port*	*Discretionary process*
		Percentage							
East Asia and the Pacific	12	92	92	75	75	83	8	83	25
Eastern Europe and Central Asia	16	75	31	19	94	31	0	94	38
Latin America and the Caribbean	24	75	29	46	58	13	4	75	29

	Number of countries surveyed	*Tax holiday tax exemption*	*Reduced tax rate*	*Investment allowance tax credit*	*VAT exemption reduction*	*Research and development tax incentive*	*Super deductions**	*SEZ/free zones /EPZ/free port*	*Discretionary process*
		Percentage							
Middle East and North Africa	15	73	40	13	60	0	0	80	27
OECD countries	33	21	30	61	79	76	18	67	27
South Asia	7	100	43	71	100	29	57	71	14
Sub-Saharan Africa	30	60	63	73	73	10	23	57	47

Source: Sebastian James, "Effectiveness of tax and non-tax incentives and investments: evidence and policy implications" (Washington, D.C., World Bank Group, September 2013).

Abbreviations: VAT, value added tax; SEZ, special economic zone; EPZ, export processing zone; OECD, Organization for Economic Cooperation and Development.

* Super deductions are deductions that exceed those normally granted to taxpayers, such as depreciation at a rate which is two to three times the standard depreciation rate.

Tax holidays

38. In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax and occasionally also from other taxes, a reduced rate of tax or a combination of the two, for example, two years' exemption plus a further three years at half the standard rate. The exemption or reduction is granted for a limited duration.

39. Tax holidays can vary in duration from as little as 1 year to as long as 20 years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than projects that are short-term and "footloose", or not tied to a particular location and able to relocate in response to changing economic conditions. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are thus quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, it is not uncommon, however, for a firm to enjoy a tax holiday in one country and, when it expires, move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

40. Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. The simplest tax holiday regime, and the most investor-friendly, provides not only that no tax is payable during the holiday period but that taxpayers are not required to file information or tax returns, which results in an absence of compliance and administrative cost. The better approach is to require the filing of a tax return during the holiday period. For example, if the enterprise is permitted to carry forward losses incurred during the holiday period or claim depreciation allowances after the end of the holiday period for expenditure incurred during the holiday, it would need to at a minimum keep appropriate records.

41. In addition, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor can the cost related to the amount of the investment or to the benefits that may accrue to the host country. Furthermore, tax holidays exempt profits with no regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[7]

Investment allowances and credits

42. As an alternative, or sometimes in addition, to tax holidays, some Governments provide investment allowances or credits. They are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable, therefore, with a corporate income tax rate of 40 per cent, an investment allowance of 50 per cent of the amount invested equates to an investment credit of 20 per cent of that amount.

43. Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Countries occasionally limit eligibility to contributions to the charter capital of the firm, an approach that may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

44. One objection to the use of investment allowances and credits is that they favour capital intensive investment and may be less favourable towards employment creation than would tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on their replacement.

45. Investment allowances and credits seem preferable to tax holidays in almost every respect: (a) they are not open-ended; (b) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (c) their maximum cost is more easily estimated. However, a recent study does find that investment credit and allowances are significantly less effective in attracting foreign investment than are tax holidays.[8]

Tax credit accounts

46. An interesting approach to offering tax benefits to potential investors that allows tax authorities to determine with great certainty the revenue costs of the tax incentive programme is to provide each qualifying investor a specific amount of tax relief in the form of a tax credit account, such as a potential exemption of $500,000

[7] Vito Tanzi and Howell H. Zee, "Tax policy for emerging markets: developing countries" (Washington, D.C., International Monetary Fund, 2000).

[8] Alexander Klemm and Stefan Van Parys, "Empirical evidence on the effects of tax incentives" (Washington, D.C., International Monetary Fund, 2009).

of corporate income tax liability.[9] The investor would be required to file tax returns and keep books and records just like any other taxpayer. If the investor determines it has $60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to $440,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the Government.

47. The tax credit account may be regarded as a hybrid of a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of taxes due on the income earned, such as in the above-mentioned example in which the exemption applies to the first $500,000 of taxable income. There are two important advantages: the cost of the incentive to the host Government is known and there is no strong built-in advantage for those investments that make quick profits. The tax credit account resembles an investment tax credit in that the amount of the credit is a fixed sum, but it differs in that the amount is not determined by the amount of the investment and consequently does not provide a preference to capital-intensive investments.

B. Implementation issues

Initial compliance with qualifying conditions

48. Initially, it must be determined whether an investor meets the qualifying conditions. Some incentive provisions require initial approval or another positive decision. For example, officials may need to determine whether the investment is in a priority sector, if the investor will meet prescribed employment or export targets and/or comply with environmental requirements. Generally, tax authorities will require some form of written certification of qualification. Another type of qualifying condition requires a determination of the nature of the investor, such as whether: the foreign participation in a joint venture exceeds a stipulated percentage; a certain number of new jobs have been created; a particular capital investment falls within a category qualifying for accelerated depreciation; or imported equipment can be classified as advanced technology. Tax authorities sometimes carry out this verification or they can require written confirmation from the appropriate authority or department. Another type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum amount stipulated to qualify for a tax holiday or that an investment qualifies for a tax credit of a given amount.

Reporting and monitoring continuing compliance

49. Conditions are sometimes attached to incentives that are related to ongoing performance, such as requirements that, throughout the tax holiday period, a given number of jobs are maintained or a certain percentage of production is exported. Such incentives require continual monitoring. Although it imposes an additional administrative burden on authorities, it does have the merit of providing the host Government with a reasonably accurate idea of how an investment is performing. Without a formal monitoring mechanism, investors have little reason to make

[9] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets" (see footnote 7 above).

realistic projections as to the number of jobs that will be created or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important to consider the Government's administrative capability to conduct the necessary monitoring when incentive legislation is drafted so that unnecessary supervision is avoided.

Common abuses of tax incentive regimes

50. Ongoing monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but to detect tax avoidance or evasion. Tax avoidance presents greater difficulties, because countries have different attitudes as to what constitutes avoidance and what to do about it. For example, granting a tax holiday may be conditional upon an investor's employing a given number of people. In some countries an investor could legitimately make up the qualifying number by hiring employees with minimal duties and at low wages. In other countries, that course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

51. Ten of the most common abuses associated with tax incentives, some of which are elaborated upon below, are:

(a) Existing firms transforming into new entities to qualify for incentives;

(b) Domestic firms restructuring as foreign investors;

(c) Engaging in transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts);

(d) Churning investments or creating fictitious investments due to lack of recapture rules;

(e) Schemes to accelerate income or defer deductions at the end of a tax holiday period;

(f) Overvaluation of assets for depreciation, tax credit or other purpose;

(g) Employment and training credits, such as fictitious employees and fake training programmes;

(h) Leakages from export zones into the domestic economy;

(i) Regional investment incentives and enterprise zones diverting activities to outside the region or zone;

(j) Disguising non-qualifying activities or burying them in qualifying activities.

Round tripping

52. Round tripping, when one company sells an unused asset to another company under the agreement that it will buy it back for the same price, typically occurs in countries where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. Domestic investors may seek to disguise their investments to qualify for those incentives by routing their investments through a wholly controlled foreign corporation. Similar practices have occurred in a number of countries with economies in transition, especially in connection with the privatization of State-owned firms in which the existing

management has acquired ownership of the firm through the vehicle of an offshore company. Round tripping is not always undertaken in order to meet foreign ownership requirements; it may also be used to take advantage of favourable tax treaty provisions.

Double dipping

53. Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective or counter-productive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to continue the activity and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs when a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the "new" investor is related to the seller, although the relationship is concealed. A more satisfactory approach for policymakers may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

Transfer pricing

54. Transfer pricing has been described as "the Achilles heel of tax holidays",[10] although it can be a problem with other forms of investment incentives. There is a tendency to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also take place in a single country in which an investor has two or more operations or derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, the investor will tend to allocate profits to the preferred activity.

55. Transfer pricing is likely to take place in the following scenarios: (a) an investor undertakes two or more activities, one of which qualifies for an incentive, such as manufacturing or exporting, and another does not; (b) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (c) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each case, the investor will wish to allocate as much profit as possible to the tax-exempt or tax-privileged entity or activity. In cases (a) and (b) there may be only a single entity, in which case there is no transfer pricing as such, but an equivalent result is achieved through the allocation of revenue and expenditure.

56. Substantial challenges exist for monitoring transfer pricing, especially for small or less developed countries. One approach may be to use tax incentives that are less prone to transfer pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period, therefore artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in its tax liability being postponed but not eliminated.

[10] Charles E. McLure, Jr., "Tax holidays and investment incentives: a comparative analysis", *Bulletin for International Fiscal Documentation*, vol. 53 (1999).

Overvaluation

57. Overvaluation, and sometimes undervaluation, is a constant problem in any tax system, and tax incentives may provide additional temptation to inflate the value of assets. For example, when granting a tax holiday is conditional upon a firm investing a certain minimum amount, the value of assets contributed to the new firm can be manipulated to achieve the target figure. This may be done legitimately, for example, by purchasing machinery rather than leasing it from independent lessors. In other cases, however, an inflated value is attributed to the property contributed, especially in cases of intellectual property. When investors also receive an exemption from customs duties for newly contributed capital, there is no motivation in terms of compensation for investors to correctly state the value or for customs authorities to monitor the declared value. A further problem may be encountered when foreign investment agencies have an incentive to boost their investment figures, resulting in a common interest between the agency and the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

Abuse of duty-free privileges

58. A common investment incentive is an exemption from customs duty on imported equipment. Once imported, however, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise, but it still may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery, which are less likely to be resold, and to exclude items such as passenger vehicles and computer equipment.

Asset stripping and "fly-by-night" operations

59. Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free profit and then leave to begin operations in another country that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. Another problem occurs when a foreign investor acquires control of an existing local enterprise and, instead of contributing new capital to modernize the enterprise, strips it of its useful assets and leaves the country. The latter problem is not necessarily linked to the availability of tax incentives, although the ability to make a tax-free capital gain is an added attraction to the investor stripping the assets.

60. Some countries have attempted to counter the fly-by-night operator problem by introducing "clawback" provisions. For example, a country can grant a tax holiday for a 5-year period only if the venture continues for a period of 10 years. If the venture is terminated before the end of the 10-year period, any tax that was foregone must be repaid. The difficulty with such a provision is that the investor may have left the country before it is possible to claw back any of the forgiven tax liability.

C. Review and sunset provisions

61. The costs and benefits of tax incentives are not easy to evaluate and are difficult to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many

countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

62. It may therefore be advisable: (a) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programmes by including a specific sunset provision as part of the original legislation; (b) to design incentive regimes that require beneficiaries to report to investment agencies and that specify which government agency is responsible for monitoring and enforcing qualification and any recapture provisions; and (c) to require an evaluation as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

D. Guidance for policymakers

63. No shortage exists of advice to policymakers; a relatively concise prescription on how to design and implement tax incentives is to keep them simple.[11] Attempts to fine-tune incentives to achieve detailed policy goals are likely to be costly to administer and unlikely to produce the desired result. The Government should diligently record the beneficiaries of tax incentives, their duration and the costs in forgone revenue. That information is necessary to ensure transparency and accountability. Governments must evaluate tax incentives' effectiveness in achieving the desired results and be willing to terminate or modify those incentive programmes that fail to achieve their objectives.

64. OECD has prepared a best practices guide to enhance the transparency and governance of tax incentives in developing countries.[12] The following actions by Governments are needed in order to implement the best practices:

(a) Make public a statement of all tax incentives for investments and their objectives within the governing framework;

(b) Provide tax incentives for investment through tax laws only;

(c) Consolidate all tax incentives for investment under the authority of one government body, where possible;

(d) Ensure tax incentives for investments are ratified through the law-making body or parliament;

(e) Administer tax incentives for investment in a transparent manner;

(f) Calculate the amount of forgone revenue attributable to tax incentives for investment and publicly release a statement of tax expenditure;

(g) Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives;

---

[11] Richard M. Bird, "Tax incentives for investment in developing countries", in *Fiscal Reform and Structural Change in Developing Countries*, vol. 1, Guillermo Perry, John Whalley and Gary McMahon, eds. (London, United Kingdom, and Canada, Macmillan in association with the International Development Research Centre, 2000).

[12] OECD, Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries. Available from http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf.

(h) Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditure, where possible;

(i) Collect data systematically to underpin the statement of tax expenditure for investment and to monitor the overall effects and effectiveness of individual tax incentives;

(j) Enhance regional cooperation to avoid harmful tax competition.

IV. Conclusion

65. Tax incentives can play a useful role in encouraging both domestic and foreign investment. The extent of their usefulness, and at what cost, depends upon how well the tax incentive programmes are designed, implemented and monitored. The present paper has examined the costs and benefits of tax incentives and the relative advantages and disadvantages of different types of incentives, as well as set out important factors to consider in designing, granting and monitoring the use of tax incentives to increase investment and growth.

66. The questions of whether to use tax incentives and what form they should take are not easy to answer. The following, however, are some clear guidelines which may improve the chances of success of tax incentive programmes: the objectives of the tax incentive programme should be clearly set forth; the type of tax incentive programme should be crafted to best fit the objective; the Government should estimate the anticipated costs and benefits of the incentive programme in a manner similar to other types of tax expenditure analysis; the incentive programme should be designed to minimize the opportunities for corruption in the granting of incentives and for taxpayer abuse in exploiting the tax benefits; the tax incentive regime should have a definite sunset provision to allow for a determination of the merits of the programme; and the Government should be required at a specific time to assess the success and failure of each incentive programme.